Internal Revenue Service

# memorandum

CC:TL-N-8365-87
Br2:DPMadden

date: AUG 19 1987

to: District Counsel, Richmond CC:RCH
Attn: Scott Anderson

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This memorandum responds to your written request for technical advice dated June 12, 1987, regarding the above-mentioned case. You have stated that you expect this case to be calendared for trial in [redacted].

## ISSUE

Whether estate tax planning expenses are deductible under I.R.C. § 212. 0212.20-00.

## CONCLUSION

The expenses incurred for tax counsel incident to estate planning are deductible under I.R.C. § 212(3). The determination of the amount of the deduction is primarily a factual one. An allocation of expenses between tax counsel and nontax counsel must be made for any bill rendered for legal services.

## FACTS

On their [redacted] joint income tax return, the taxpayers claimed a miscellaneous itemized deduction of $[redacted] for estate planning. The file contains a copy of a bill from the taxpayers' counsel dated [redacted], showing the following charges for legal services rendered to the taxpayers:

| | |
|---|---|
| Tax research and consultation | $[redacted] |
| Drafting estate planning documents | [redacted] |
| Recording fees | [redacted] |
| Total | $[redacted] |

To date, the taxpayers have not substantiated the additional $[redacted] included in the amount deducted on their tax return.

The research and documentation connected with the estate plan included obtaining written appraisals for the real estate interests being transferred and preparation of the following documents:

1. will for [redacted];
2. will for [redacted]
3. trust agreement of [redacted];
4. powers of attorney for [redacted], and [redacted];
5. private annuity agreement for the purchase of the remainder interest in real estate;
6. deeds of bargain and sale for the purchase of the remainder interest for [redacted] and [redacted] real estate.

None of the legal fees affected property held for the production of income. The main purpose of the fee was simply to transfer the ownership of the assets.

We understand your request for technical advice to raise the following questions:

Whether I.R.C. § 212(3) allows the deduction of tax counsel expenses incident to estate planning:

(a) where the tax counsel concerns future tax consequences rather than current taxable events; and,

(b) where the tax counsel benefits the future estate and not merely the taxpayer taking the deduction.

## DISCUSSION

A. Service position.

I.R.C. § 212 provides:

> In the case of an individual, there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year--
>
> (1) for the production or collection of income;
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> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

Treas. Reg. § 1.212-1(a) states:

> An expense may be deducted under section 212 only if-
>
> (1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of income, or (iii) in connection with the determination, collection, or refund of any tax; and
>
> (2) it is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

Treas. Reg. § 1.212-1(l) provides:

> Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible. (emphasis added.)

The extent to which expenses for tax counsel are deductible under I.R.C. § 212(3) and Treas. Reg. § 1.212-1(l) was considered in several cases in the 1960s and early 1970s. The Service took the position that expenses for tax counsel were deductible under these sections only if the tax counsel concerned the determination, collection, or refund of a tax. The courts generally took a liberal view of the Code to permit the deduction. See, e.g., Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961), aff'd on other issues sub nom. United States v. Davis, 370 U.S. 65 (1962); Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964). The Actions on Decision issued for these cases recommended that the Treasury regulation be reconsidered in light of these decisions. See, e.g., Thomas Crawley Davis v. United States, A.O.D., O.M. 13348 (May 2, 1961).

On July 16, 1965, a conference between representatives of the Refund Litigation Division and the Legislation and Regulations Division was held to determine whether Treas. Reg. § 1.212-1(l) should be amended to limit the deductibility of expenses of tax counsel or whether the Service should conform its litigating policy to the existing regulations as interpreted by the courts. The decision was to change the litigating policy. Lee, Toomey and Kent, G.C.M. 34993, I-4730, at 5 (August 17, 1972). The Refund Litigation Division thereafter issued revised Actions on Decision stating that expenses properly allocable to tax advice are deductible under I.R.C. § 212(3). Kaufmann v. U.S., A.O.D., O.M. 15050 (September 16, 1965); and, Carpenter v. U.S., A.O.D., O.M. 15196 (September 16, 1965). The position in these revised Actions on Decision was reaffirmed following the partial Service loss in Merians v. Commissioner, 60 T.C. 187 (1973), in Sidney Merians, O.M. 17896, I-306-73 (July 10, 1973).

The Service thereafter published Rev. Rul. 72-545, 1972-2 C.B. 179, which discusses the deductibility of legal fees in the divorce context. The ruling notes Treas. Reg. § 1.212-1(l) and then states that "[i]n order for an expense to be deductible under Section 212(3) of the Code, it must relate solely to tax counsel. If such expense is incurred in connection with an activity that is not solely concerned with tax matters, the expense for tax counsel must be properly allocated and substantiated." Rev. Rul. 72-545, 1972-2 C.B. 179 (citations omitted). The G.C.M. considering the revenue ruling acknowledges the judicial history of interpretation of the regulation and the establishment of the Service position: "The current position of the Service, as reflected by its litigating policy, is that expenses incurred for all tax advice are deductible

under section 212(3), and that the determination [of the amount of the deduction] is primarily a factual one." G.C.M. 34993 at 6. 1/

We believe that the expense for tax counsel incident to estate planning is deductible under I.R.C. § 212(3). While Rev. Rul. 72-545 concerns legal fees incident to divorce proceedings, its broad language and cited authorities extend beyond only that type of fee. In situation (2) in that ruling, the taxpayer engaged tax counsel to advise him of, among other things, the federal estate tax consequences to him of establishing a trust incident to his divorce. The ruling's holding that the expense for that counsel was deductible directly supports the deduction of estate tax

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1/ The current Service position on the deductibility of tax counsel expenses is also in accord with the drafters of Treas. Reg. § 1.212-1(l). On August 18, 1956, the Department of Treasury proposed regulations under I.R.C. § 212(3). See 26 Fed. Reg. 6228 (August 18, 1956). Prop. Treas. Reg. § 1.212-1(l) provided:

> Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses incurred in connection with the preparation of tax returns or in connection with proceedings involved in determining the extent of tax liability or in contesting a tax liability are deductible.

See 22 Fed. Reg. at 6229-30.

Before final promulgation, however, the second sentence of the regulation was amended and now reads:

> Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

See Treas. Reg. § 1.212-1(l) (emphasis supplied to show amendment).

(footnote continued)

planning fees. Also, the statement of Service position in the G.C.M. that expenses incurred for all tax advice does not admit of any limitation regarding the purpose for the advice. The deductibility of the expense for tax counsel depends on the proper allocation and substantiation.

You have inquired whether the fact that estate planning concerns future events has a bearing on the deductibility of the expense of tax counsel. We do not believe that it has any effect for two reasons. First, case law and Service position do not support denying a deduction based on this factor. See Carpenter, 338 F.2d 366; O.M. 15196; Rev. Rul. 72-545 (in situation (2), holding in part that the expense for advice concerning the estate tax consequences to the taxpayer were deductible). Second, the deductibility of estate tax planning fees should be consistent with the deductibility of investment advice, especially as it concerns estate planning. Estate planning services typically involve the planning and rearranging of the potential estate so as to increase its yield and reduce income and estate taxes. In this regard, tax counsel may become intertwined with investment advice. Treas. Reg. § 1.212-1(g) provides in general for the deduction of ordinary and

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(footnote continued) A technical memorandum for the Secretary of Treasury stated the reasons for the amendment. The first was to clarify that the expenses concerned must relate to the taxes of the person claiming the deduction. The second reason is quoted.

> In addition, largely as a clarifying matter, it has been made clear that expenses for tax counsel are deductible. The paragraph as it appeared in the notice [of proposed rulemaking] carried the implication that some liability must exist. In view of the Service's acquiescence in Nancy Reynolds Bagley, 8 T.C. 130, and Philip D. Armour, 6 T.C. 359, it was thought that provision should be made for the deduction of the cost of tax counsel unrelated to a return or contest.

Memorandum for Hon. Robert B. Anderson from the Commissioner of Internal Revenue regarding Proposed Treasury Decision prescribing regulations under sections 211, 212, 213, 215, and 217 (contained in T.D. 6279 file).

It is unclear why the Government pursued litigation contesting the deductibility of tax counsel expenses under I.R.C. § 212(3) in the 1960s and early 1970s given this evidence of the drafters' intent. In any event, current Service position is consistent with the intent of the drafters and looks only to allocation and substantiation of the claimed expense.

necessary fees for investment counsel. The Tax Court has recently reaffirmed the general deductibility of expenses for investment advice dealing with future investments, although it recognized that some otherwise deductible expenses must be capitalized in certain situations. "Fees paid for investment counsel and advice concerning existing and future or potential investments have been held to be deductible .... However, expenses that are capital in nature are not deductible under section 212 because such expenditures fail to satisfy the 'ordinary and necessary' requirement of that section. Sec. 1.212-1(n), Income Tax Regs. ...." Honodel v. Commissioner, 76 T.C. 351, 364 (1981), aff'd, 722 F.2d 1462 (9th Cir. 1984).

You have also inquired whether the expense for tax counsel connected with estate planning should be nondeductible because the individual taxpayer and his estate are two separate taxpaying entities and allowing the individual to deduct expenses pertaining to another entity is contrary to basic taxation theory. We do not believe that this argument precludes the deduction of tax counsel expenses by the individual taxpayer. An individual's estate is not a taxpaying entity until it comes into existence at his death. Thus, at the time the expense for estate planning is incurred, there is only one taxpaying entity. Also, it is the individual and not his estate who pays or incurs the expense of the estate planning. Thus, only he can possibly be eligible for claiming the deduction for the expense. Furthermore, estate planning advice relates to the individual's income and gift tax liabilities, as well as estate tax consequences.

B. General guidance regarding allocation to tax counsel.

I.R.C. § 212(3) allows as a deduction all ordinary and necessary expenses for tax counsel. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to tax matters. Treas. Reg. § 1.212-1(d); Trust of Bingham v. Commissioner, 325 U.S. 365 (1945). Reasonableness and proximity are generally questions of fact. If an expense is incurred in connection with an activity that is not solely concerned with tax matters, then the expense for tax counsel must be properly allocated and substantiated. See Rev. Rul. 72-545, 1972-2 C.B. 179.

There is no definitive demarcation between tax matters and nontax matters with respect to estate planning activities. The Tax Court in Merians v. Commissioner, 60 T.C. 187 (1973), acq. 1973-2 C.B. 2, recognized that an allocation must be made if there is sufficient evidence in the record.

> A complete analysis of an estate involves more than a consideration of the tax consequences; in fact, it is basically

> concerned with transferring the client's property to the persons he wishes to receive it. The client's financial condition, the nature of his property, the extent to which he wants various persons to share in his estate, the needs and capacity of each intended beneficiary, the details of State law, and the need for flexibility are among the multitude of factors which are considered in establishing a plan to dispose of a client's wealth.

Merians, 60 T.C. at 189.

The court listed some of the substantial nontax considerations involved in estate planning: each beneficiary's ability to handle funds; the state of title of the client's property; the amount of control which the client desired to maintain over the property during his life; the client's present and future financial needs; the reliability of potential trustees; and the State law difficulties which might be encountered in disposing of the client's property. See Merians, 60 T.C. at 189. It also warned that "in establishing an estate plan, choices made for personal nontax reasons may have tax implications, but the consideration of such implications does not convert into tax advice the advice given concerning nontax problems." See Merians, 60 T.C. at 189.

The Tax Court has stated that the expense of preparation of a will is a personal nondeductible expense. See Schultz v. Commissioner, 50 T.C. 688, 700 (1968), aff'd per curiam, 420 F.2d 490 (3d Cir. 1970). It relied on Estate of Pennell, 4 B.T.A. 1039 (1926) for support. In that earlier case, the Board ruled that the expense for general personal legal services, including the preparation of a will, were not business expenses, and that the petitioner failed to prove that any of the particular expenses at issue could be properly classified as business expenses. There was no comparable provision to I.R.C. § 212(3) in the Code at that time. We have concluded that I.R.C. § 212(3) now permits the deduction of expenses for tax counsel. You have indicated that wills were prepared for the petitioners in your case. If the taxpayers can demonstrate that a part of the expense for preparation of the wills was properly allocable to tax counsel, they should be allowed a deduction to that extent. However, the drafting of the documents and consideration of the various nontax matters did not give rise to deductible expenses.

Courts have permitted the deduction of expenses for setting up a trust depending on the nexus between the trust and the management of income producing property. In Bagley v. Commissioner, 8 T.C. 130 (1947), acq., 1947-1 C.B. 1, the Tax Court held that a fee paid for estate planning which effected a substantial rearrangement and reinvestment of the petitioner's entire estate of income producing

properties was deductible under the predecessor to I.R.C. § 212(2). The same court held that other fees paid concerning the nature and type of securities and cash which should be set aside from petitioner's property to form the corpus of a trust in favor of the petitioner's daughter were nondeductible. The court was unable to discern the proximate connection between the disposition of income-producing property by gift in trust and the management, conservation, or maintenance of that property. See Bagley, 8 T.C. at 135. Although the Bagley opinion was based on an interpretation of the predecessor to I.R.C. § 212(2), the Tax Court cites to it for the broader proposition that amounts paid for advice with respect to the planning of one's personal and family affairs, such as the establishment of trusts for family members or making gifts, are nondeductible personal expenses. See Epp v. Commissioner, 78 T.C. 801, 805 (1982). Amounts which are properly allocable to tax counsel with respect to the establishment of a trust or making gifts are deductible. Rev. Rul. 72-545, 1972-2 C.B. 179. You have stated in your request for advice that none of the legal fees affected property held for the production of income and that the main purpose for the fee was to transfer ownership of the assets. We agree that the portion of the fees properly attributable to efforts to transfer ownership of assets are nondeductible personal expenses. If the petitioner provides evidence that a part of the fees were for tax counsel, for instance, in setting up a qualifying marital deduction trust, then that part would be deductible under I.R.C. § 212(3).

Finally, you should note the general restriction and limitations on deductibility of expenses under I.R.C. § 212 found within the regulations to that section. For example, I.R.C. §§ 261 et seq. apply as limitations to I.R.C. § 212. Treas. Reg. § 1.212-1(e). Two sections may be particularly relevant to estate planning. The first is I.R.C. § 265 which provides in part that no deduction is allowable under I.R.C. § 212 for any amount allocable to the production or collection of income which is not includible in gross income. If any part of the estate planning tax counsel related to the production or collection of tax exempt income, the expense for that tax counsel is nondeductible.

The second potentially applicable section is I.R.C. § 263, which proscribes the deduction of capital expenditures. A part of the tax counsel given to the petitioners may have concerned the acquisition or disposition of capital assets. As such, the expense attributable to that part would have been nondeductible, and capitalized into the cost of the asset. Treas. Reg. § 1.212-1(n); United States v. Gilmore, 372 U.S. 39 (1963).

In summary, it is Service position that estate planning expenses properly allocable to tax counsel are deductible under I.R.C. § 212(3). The petitioners should provide evidence supporting a proper allocation of the legal fees paid for the estate planning between tax advice, which is deductible, and nontax advice, which is not.

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